Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Event Update

# Dr. Reddy's Laboratories Ltd

## Carving a sustainable growth path

| Pharmaceuticals | | Sharekhan code: DRREDDY | |
|---|---|---|---|
| Reco/View: Buy | ↔ | CMP: Rs. 4,251 | Price Target: Rs. 5,550 ↔ |

↑ Upgrade ↔ Maintain ↓ Downgrade


### Summary

- We retain our Buy recommendation on the stock with an unchanged PT of Rs. 5,550.
- In its investor's day, DRL has unveiled its two-pronged growth strategy across its business which could propel the growth. In the short to medium term DRL intends to focus on existing business/ products lines while over the long-term new areas such as differentiated formulations, CDMO and Biologics would be the focus area.
- Basis the growth strategy unveiled DRL has guided for a double digit revenue growth and EBITDA margins at 25% over the medium term.
- Near-term challenges in the form of elevated cost pressures, demand volatility, price erosion and geo-political issues could affect the performance, though DRL's long-term growth levers are intact.


**Dr. Reddy's Laboratories (DRL) hosted an investor's day on 21st June 2022 and the commentary from the management pertaining to the growth outlook was encouraging. DRL has charted out a two pronged growth strategy encompassing all its business segments and spread across two horizons – 1 &2. Under Horizon 1 (H1) DRL plans to focus on the existing business to support growth over the next 2-3 years while under Horizon 2 (H2) it would focus on scaling up / creating new growth engines and is likely to commence meaningful contribution from FY27 onwards. While the strategy outlined would drive the growth for DRL over the long term, cost pressures, demand volatility and geo-political pressures could play near term dampeners. Overall basis the above, DRL looks to sustain the double digit topline growth over the medium term and aims for a 25% EBITDA margins.**

- **Horizon 1 – Emphasizes the short to medium-term focus areas for growth:** One part of DRL's two pronged growth strategy unveiled by the company focuses categorically on growing the existing business and defining strategy that could propel the growth over the next 2-3 years. Some of the key areas that DRL plans to focus on is the Generics, branded generics, Biosimilars, API and OTC business. These collectively form the existing business lines and through a strong product portfolio (including complex products as well), market expansion and product-related opportunities, along with leveraging multiple platform technologies such as particulate system, Microsphere, Liposomal, Peptide platforms, Emulsions and suspensions technologies, would drive the growth for DRL under H1.
- **Horizon 2 – Emphasis on creating new growth engines and focus on long-term growth:** DRL's H2, which is the second part of its growth strategy would emphasize building the future with a focus on the identifying and building new growth engines. Under the H2 DRL looks to scale up Immuno-oncology NCEs, CDMO and Neutraceuticals along with a focus on new spaces like Preventive & primary care platform SVAAS, Differentiated formulations, Disease management and Biologics and cell and gene therapy. The key areas of focus classified under H2 are expected to commence contributing to the overall company's growth from FY27 and provide ample visibility on growth.
- **Growth outlook:** DRL bases its two-pronged growth strategy aspires for / guided for serving around 1.5 bn patients which is 3x from its current baseline and also expect to stage a double-digit topline growth. Further DRL has targeted EBITDA Margins to be at 25% levels as against 22.9% in FY22 in the medium term. In addition to the above, DRL is also aspiring for a Global product pipeline focusing on non-US markets and would be driven by new product introductions and foray into new markets. The management has also guided for improving the productivity through various efficiency improvement measures.

### Our Call

**Valuation: Carving out a sustainable growth path; retain buy:** DRL has unveiled its two-pronged growth strategy across its business which could propel the growth over the short to medium term and long term tenures. In the short to medium term (H1) DRL intends to focus on existing business/products lines while over the long term new areas such as differentiated formulations, CDMO and Biologics amongst others would drive the growth. However cost pressures, demand volatility and geopolitical tensions could act as near-term dampeners. At the CMP, the stock is trading at a P/E multiple of 20.7x/18.2x its FY23E/FY24E EPS. While near-term cost pressures could affect the performance, DRL's long-term growth levers are intact. We retain our Buy recommendation on the stock with an unchanged PT of Rs. 5,550.

### Key Risks

1) Adverse development on the regulatory front including outcome of inspections can impact earnings prospects; 2) currency fluctuation risk

**Valuation (Consolidated)** Rs cr

| Particulars | FY2021 | FY2022 | FY2023E | FY2024E |
|---|---|---|---|---|
| Net sales | 18420.2 | 20514.4 | 23652.2 | 25787.5 |
| EBITDA | 4546.7 | 4698.1 | 5864.2 | 6543.6 |
| EBITDA (%) | 24.7 | 22.9 | 24.8 | 25.4 |
| Adj PAT | 1951.6 | 2182.5 | 3416.3 | 3878.0 |
| EPS (Rs) | 117.6 | 131.5 | 205.8 | 233.6 |
| PER (x) | 36.2 | 32.3 | 20.7 | 18.2 |
| EV/Ebidta (x) | 14.3 | 13.3 | 10.9 | 9.1 |
| P/BV (x) | 4.0 | 3.7 | 3.4 | 3.0 |
| RoCE (%) | 12.7 | 11.4 | 17.6 | 18.1 |
| RoNW (%) | 11.1 | 11.4 | 16.4 | 16.4 |

*Source: Company; Sharekhan estimates*

### 3R MATRIX

| | + | = | - |
|---|---|---|---|
| Right Sector (RS) | ✓ | | |
| Right Quality (RQ) | ✓ | | |
| Right Valuation (RV) | ✓ | | |

\+ Positive = Neutral – Negative

### What has changed in 3R MATRIX

| | Old | | New |
|---|---|---|---|
| RS | | ↔ | |
| RQ | | ↔ | |
| RV | | ↔ | |

### ESG Disclosure Score NEW

ESG RISK RATING 31.35

Updated Apr 08, 2022

High Risk

| NEGL | LOW | MED | HIGH | SEVERE |
|---|---|---|---|---|
| 0-10 | 10-20 | 20-30 | 30-40 | 40+ |

*Source: Morningstar*

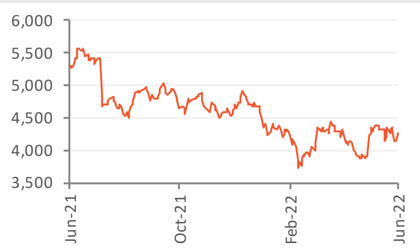
### Company details

| | |
|---|---|
| Market cap: | Rs. 70,737 cr |
| 52-week high/low: | Rs. 5,614 / 3,655 |
| NSE volume: (No of shares) | 4.7 lakh |
| BSE code: | 500124 |
| NSE code: | DRREDDY |
| Free float: (No of shares) | 12.2 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | 26.7 |
| FII | 28.4 |
| DII | 22.3 |
| Others | 22.6 |

### Price chart



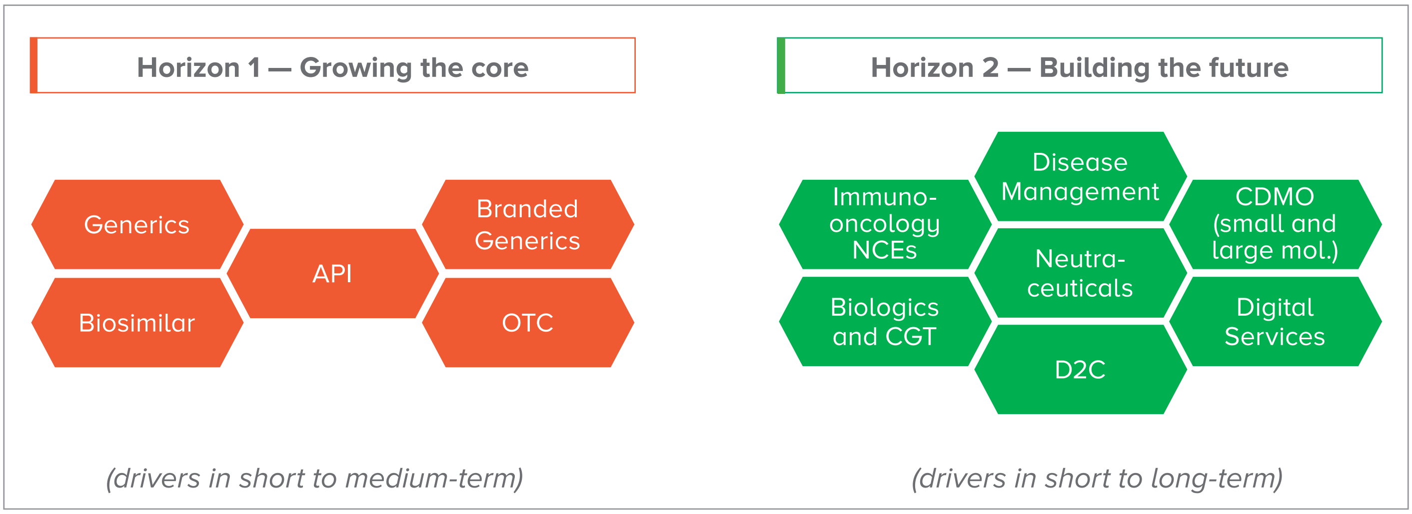

### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 0.1 | 5.4 | -8.6 | -19.9 |
| Relative to Sensex | 4.7 | 16.1 | 0.3 | -18.5 |

*Sharekhan Research, Bloomberg*

DRL had hosted an investor's day on 21st June 2022 and in that the company has laid out its growth strategies over the near term as well as long term. While in the near term the company plans to focus on the existing lines of business across the geographies and has classified it has focus areas in Horizon 1 (H1). However, in the long term, the DRL has identified the areas of growth which focus on building new growth engines spread across geographies and had classified these under Horizon 2 (H2). In addition to the above, the company has plans to improve productivity as well as operational efficiencies and has charted out a growth plan for the same. Also, the company plans to leverage Horizon 1 (H1) growth levers which would enable it to invest in Horizon's two initiatives which have been charted out. However, while the company's growth plans would play out in the long term, in the near term inflationary environment, demand volatility, continued price erosion (especially in the US) and geo-political uncertainties could pose a challenge. Basis the above, the company has guided for a double-digit sales growth and an EBITDA margin of 25% over the medium term and this bodes well from a growth perspective.

**Growth plans across two Horizons**

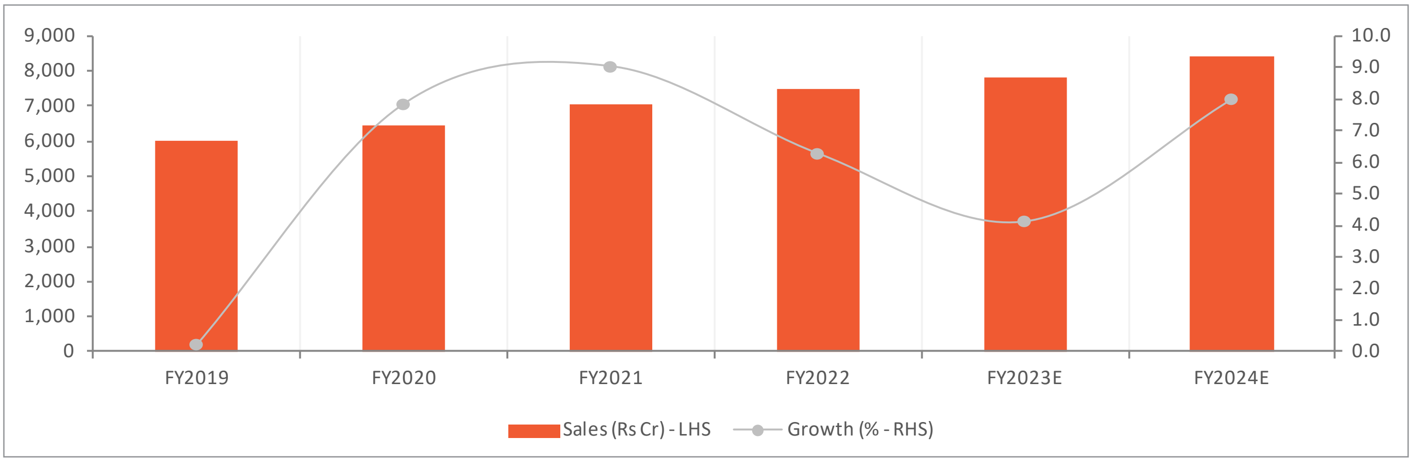



*Source: Company; Sharekhan Research*

**Strong product pipeline in the US to drive the growth; price erosion to stay:**

DRL's US sales for Fy22 stood at Rs 7491.5 cr up6.3% y-o-y and reported a 7.7% CAGR over FY2019 to FY2022. The growth in FY2022 comes despitepricing pressures sustaining in double digits and was driven by a strong product portfolio consisting of 335+ products in the US markets of this around 160 products have been commercialized while the balance is in various stages of pipeline. DRL has a total of 175 products in the pipeline at various stages and this points to a strong product pipeline. Of this around 40% of the products are injectable while 25+ are complex products across Drug-device combos, peptides, and long-acting Injectable. Further DRL has a sizeable market share in a few of the products like - Ciprofloxacin Dexamethasone (43%), Metoprolol ER (25%) and Liposomal Doxorubicin (45%). It also holds a 19% and 12% market share in gSuboxone and Icosapent Ethyl respectively. As a part of the growth strategy, the company has identified focus areas across H1 and H2 which could propel the growth in the times ahead. Focus to grow the injectable business, efforts to develop an agile business model and imprpve productivity in retail generics through OTC – private label and brand scale, strengthening Direct-to-patient channels would be the drivers for the growth in the H1 in the near term, while over the long term in H2 the new areas of biosimilars, Drug-device combination, Immuno-oncology, and digital led self-care and wellness solutions would be the key focus areas. Overall, new product launch intensity has been strong; and going ahead, the product launch intensity is likely to be healthy with DRL planning to launch 20-25 new products in the US markets in FY23, which could enable the company to tide over the double-digit pricing pressures in the US and provide ample growth visibility going ahead.

**US business sales trends**




*Source: Company; Sharekhan Research*

## Europe business well placed to clock a double-digit growth

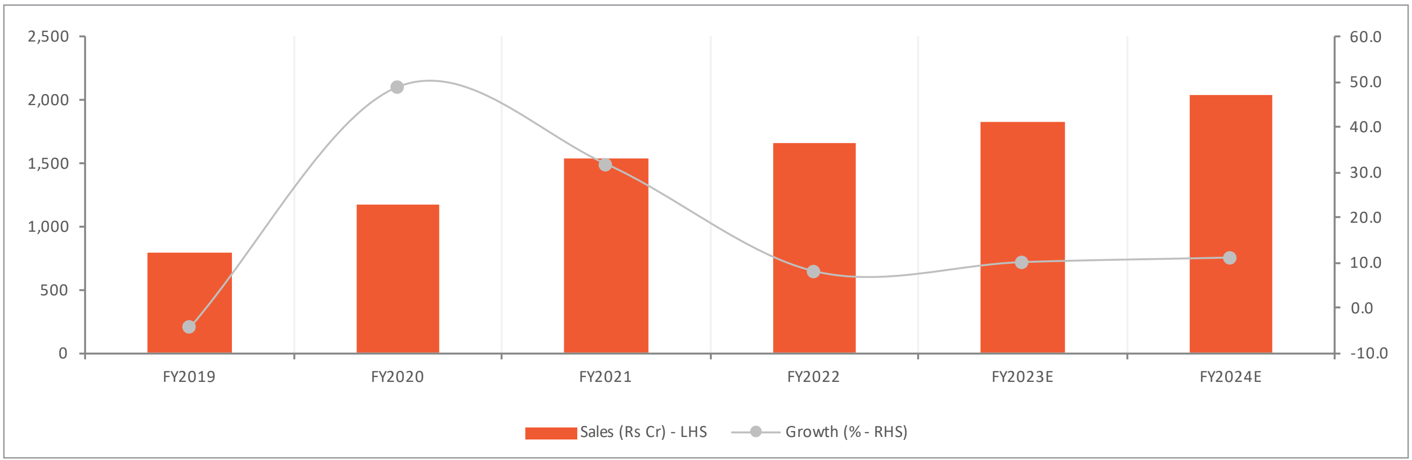
DRL's Europe business has staged a strong healthy growth over FY2019 to FY2022 with the revenues increasing from Rs 787 cr in FY2019 to Rs 1663 cr in FY2022. The strong growth is largely driven by the expansion in the product portfolio and entry in the new markets. In the previous year, DRL entered 5 new markets and plans to pursue its entry in new markets. Also, the new market entry strategy is well complimented by the strong product portfolio consisting 160 products and is expected to grow going ahead. DRL has products across the biosimilars, complex generics and other generics space in the Europe markets. Going ahead DRL has outlined growth strategies for the Europe markets spread across the existing lines of business as well as new growth areas which would propel the growth for the company. In the near term under H1 DRL in Europe, markets plan to build scale in EU 5 – Germany, UK, Spain, France and Italy, pursue selective geographical expansion and increase first-to-market launches by leveraging current portfolio. While over the long-term tenure under H2 DRL plans to focus on ramping up the branded business with differentiated branded and OTC play, pioneering in the new areas of Pharmaceutical cannabis and Biosimilars.

**Europe - Pipeline of Biosimilars and Generics**

| Biosimilars | Complex Generics | Other Generics |
|---|---|---|
| Pegfilgrastim | Liraglutide | Apixaban |
| Rituximab | Doxorubicin liposomal | Rivaroxaban |
| Tocilizumab | | DMF |
| Abatacept | | Sacubitril |

*Source: Company; Sharekhan Research*

**Europe Business Sales Trends**

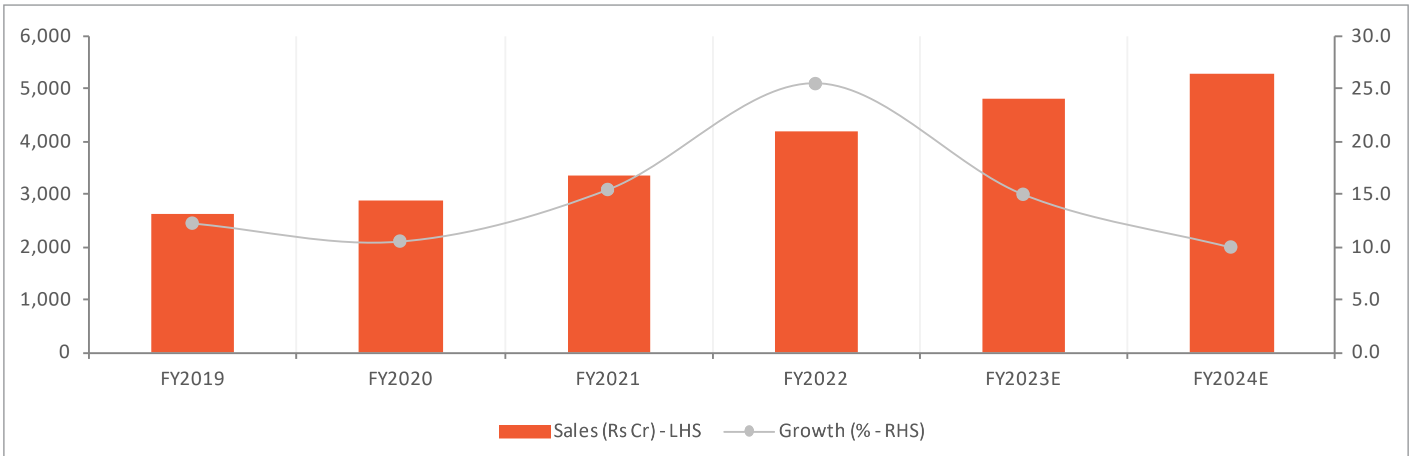



*Source: Company; Sharekhan Research*

### India Business to stage a double-digit growth and outperform the IPM

DRL's revenues from the India business have staged a strong market-beating 17% CAGR over FY2019 to FY2022, with an impressive 25.5% y-o-y growth reported in FY2022. The overall strong growth in the India business could be attributable to growth in the key brands which have a sizeable market presence. Two of its brands OMEZ & OMEZ-D and ZEDEX & BRO-ZEDEX command a Rs 389 crore and 305 cr market size respectively. The other brands such as Atarax and Razo – D have a market size of around Rs 162 cr and Rs 134 crore respectively. DRL's 16 brands are in the IPM in the top 300 while 15 brands in total have a market size greater than Rs 100 cr. DRL's near-term strategy for the India markets under H1 includes Building big brands through strong product management processes, winning in chosen therapy/ disease areas through differentiated portfolio & inorganic play and Productivity through sales & marketing excellence using Digital & Analytics i.e. leveraging the digital platform. While over the long term under H2 DRL intends to focus on new areas of - Nutraceuticals and OTC, Biologics and CAR-T, NCE / NBE and Condition & disease management and digital ecosystem play. Overall given the strong product portfolio, price hikes announced and focus to expand the reach, DRL expects the India business to stage a double-digit growth and outperform the IPM growth.

**India Business Sales trends**

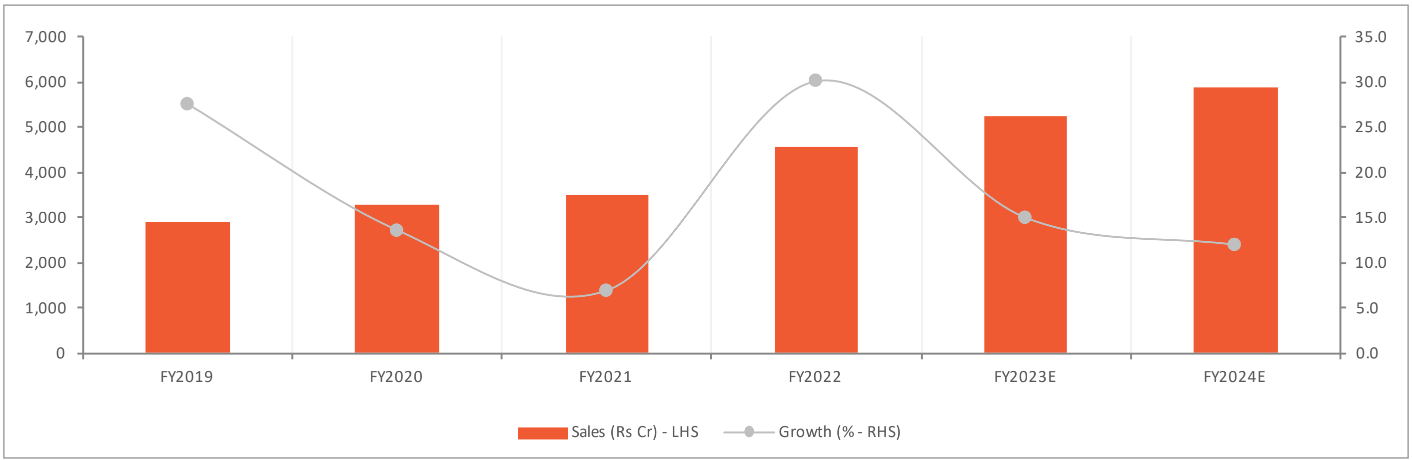



*Source: Company; Sharekhan Research*

**Emerging Markets on a healthy growth path driven by a focus on China and Brazil markets**

DRL's revenues from the Emerging markets have staged a strong 16.5% CAGR over FY2019 to Fy2022, with a strong 30% y-o-y growth in FY2022. Growth could be attributable to market expansion, a strong product portfolio and strong branding capabilities. DRL in the Emerging Markets entered in 13 new markets in the last 5 years and has a strong portfolio of products with 564 products filled. Going ahead the company sees Russia, China and Brazil to be the growth drivers for the segment. In China backed by a double-digit filling momentum, DRL looks to grow 2x-3x in China over the next 5 years while focus on growing the oncology and institutional segment, DRL aims for a 4x-5x growth in Brazil in the next 5 years. Overall in the near term under H1 DRL plans to grow Megabrands in Rx and OTC, leverage its global portfolio into EM Geography Reach and Productivity Growth through Selling & Marketing excellence to be the key growth drivers. Collectively, basis the above the revenues from the emerging markets segment are expected to stage a healthy growth momentum.

**Emerging Markets Business Sales Trends**



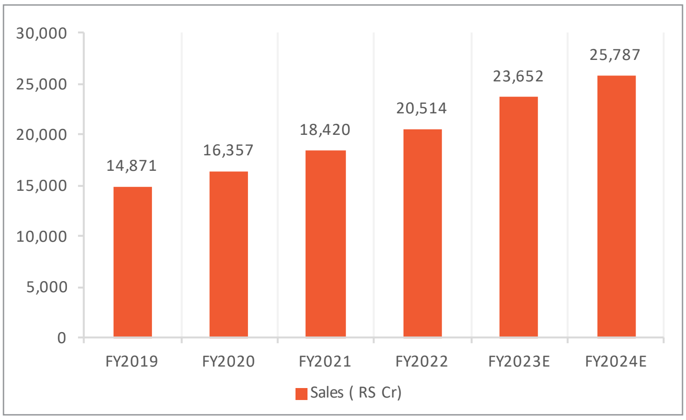

*Source: Company; Sharekhan Research*

**Biologics business gradually on a ramp up mode:** DRL is scaling up to build a global Biosimilars business in H1 and CGT and CDMO in H2. With the approvals from the highly regulated markets coming, DRL is committed to building a global biosimilar business. In addition to this DRL has a portfolio of 6 commercial products in India and around 25 plus products commercialized in Emerging markets. With respect to the Pipeline, DRL plans to focus on areas of Oncology and Autoimmune disease with 12 products in the pipeline across various stages of development and by FY23 the company expects 2 assets to enter the clinical stage and expects 2 other assets to be scaled up. Collectively DRL sees a robust pipeline of ~$50 bn of innovator peak sales to drive the growth in H1, while in H2 it plans to focus on new areas of Cell and Gene therapy and CDMO biologics.

**Near term, concerns to Stay:** DRL is witnessing challenges in the form of cost pressures as well as price erosion, especially in the US markets. Given the sustained cost pressures, the operating margins for FY2022 have contracted to 22.9% as compared to 24.7% in FY2021. Going ahead the management sees challenges to sustain in the near term which include an inflationary environment (with raw material cost and freight cost on the higher side), demand volatility, Price erosion (in double digits in the US which is a key market for DRL) and geopolitical issues, which could impact the margins as well as also exert pressures on the working cap cycles. Basis this DRL expects the near-term volatility to sustain, while in the long term the strategies charted out by the company under H1 and H2 would play out and are expected to support the growth.

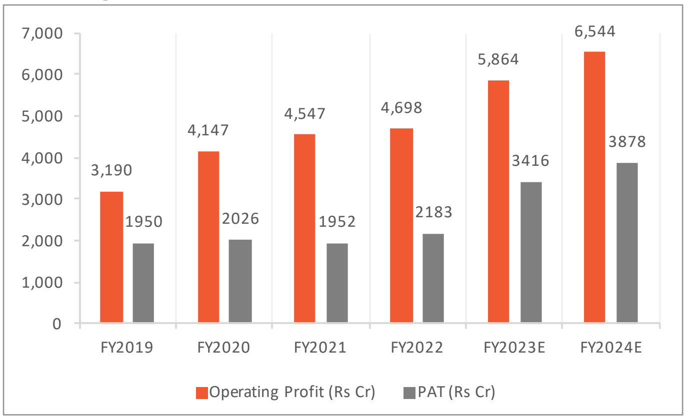
## Financials in charts

**Sales Trends Rs Cr**



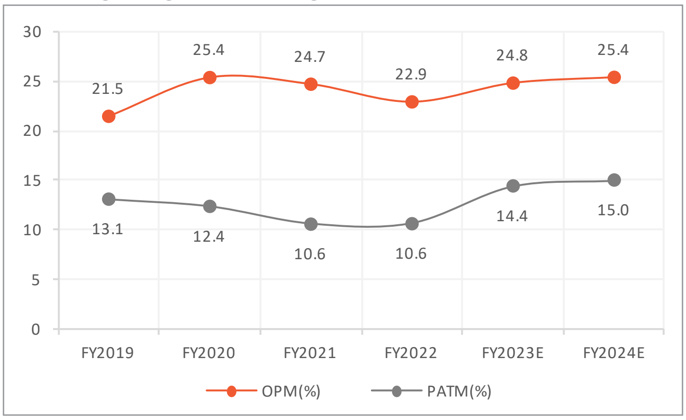

*Source: Company, Sharekhan Research*

**Operating Profit - PAT Trends**



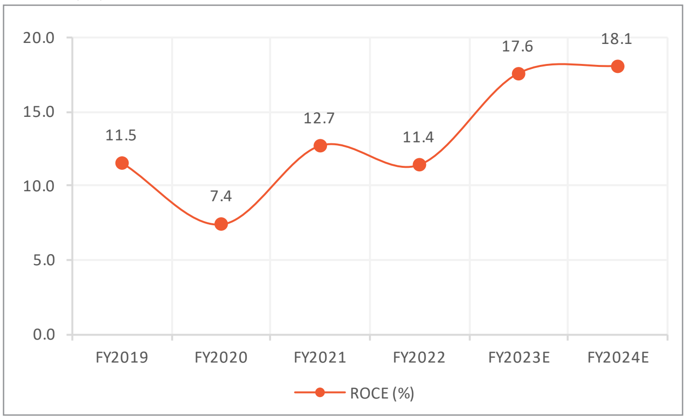

*Source: Company, Sharekhan Research*

**Operating Margin - PAT Margins**



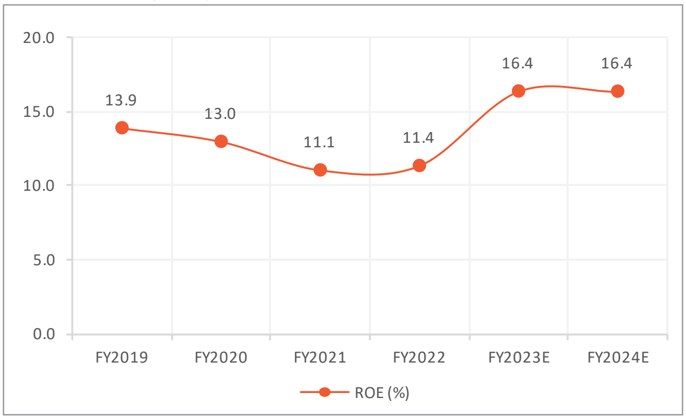

*Source: Company, Sharekhan Research*

**ROCE (%)**



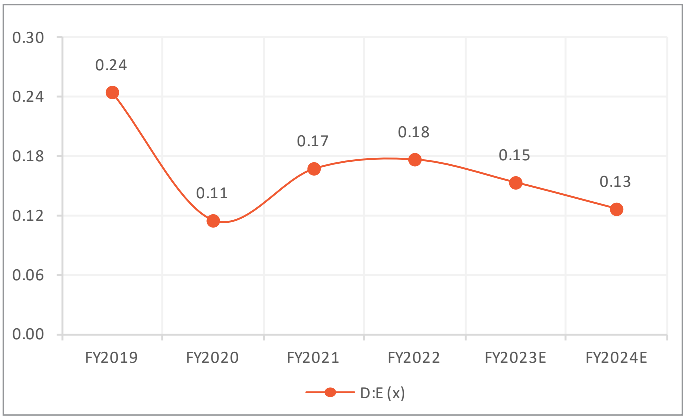

*Source: Company, Sharekhan Research*

**Return ratios (ROE) to improve**




*Source: Company, Sharekhan Research*

**Debt : Equity (x)**




*Source: Company, Sharekhan Research*

## Outlook and Valuation

### ■ Sector View – Growth momentum to improve

Pharmaceutical companies are better placed to harness opportunities and report healthy growth going ahead. Indian companies are among the most competitive ones globally and hold a sizeable market share in most developed as well as other markets. Moreover, other factors such as easing of pricing pressures (especially in the US generics market), rise in product approvals, and plant resolutions by the USFDA coupled with strong growth prospects in domestic markets and emerging opportunities in the API space would be key growth drivers. This would be complemented by strong capabilities developed by Indian companies (leading to a shift towards complex molecules and biosimilars) and the commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharmaceutical companies.

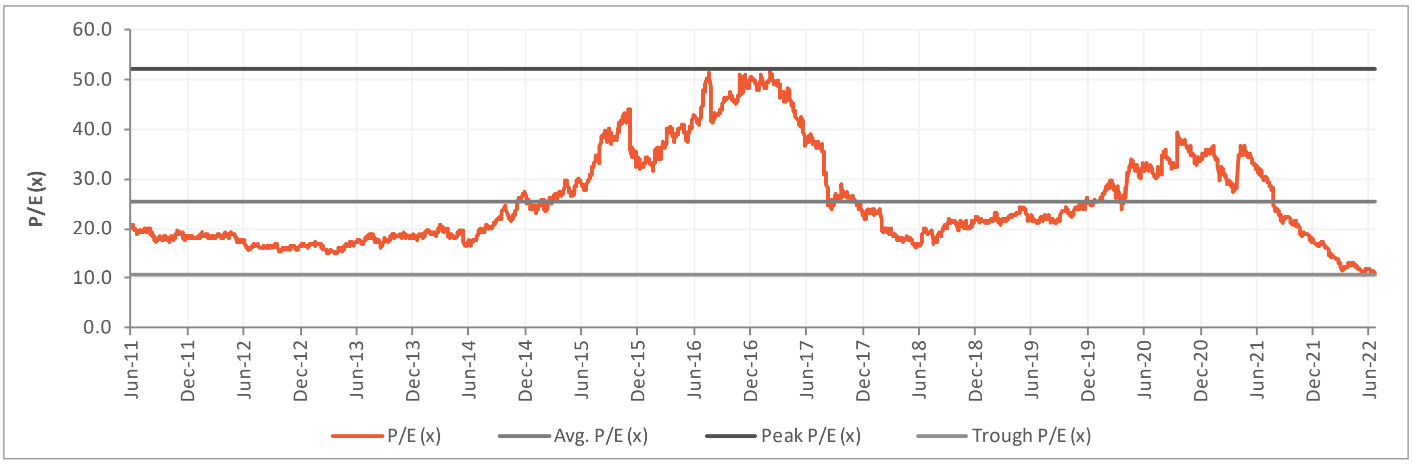
### ■ Company Outlook – Outlines two-pronged growth strategy

DRL has a global presence, especially in the formulations segment. Globally, the company is present in most markets with US and India accounting for ~35% and 20%, respectively, of overall sales. Also, the management has charted out key focus areas to be chased for growth over the near term (under Horizon 1) and over the long term (under Horizon 2) which would propel the growth going ahead. A confluence of cost control as well as productivity improvement measures, synergies through partnerships, market and product portfolio expansion, strong execution, and product-specific opportunities would be key growth drivers. Moreover, with the base business diversifying, performance is expected to gather pace, backed by geographical expansion. A strong product pipeline in the US generics business and improvement in the existing business would fuel US sales. On the other hand, likely traction in acute therapies and acquired portfolio coupled with efforts to expand geographically and leverage the digital platform to grow brands would be key drivers for Indian business. However, the PSAI segment's performance is expected to be soft in the near term with a likely gradual improvement.

### ■ Valuation – Carving out a sustainable growth path; retain buy

DRL has unveiled its two-pronged growth strategy across its business which could propel the growth over the short to medium term and long term tenures. In the short, to medium term (H1) DRL intends to focus on existing business/products lines while over the long term new areas such as differentiated formulations, CDMO and Biologics amongst others would drive the growth. However, cost pressures, demand volatility and geopolitical tensions could act as near-term dampeners. At the CMP, the stock is trading at a P/E multiple of 20.7x/18.2x its FY23E/FY24E EPS. While near-term cost pressures could affect the performance, DRL's long-term growth levers are intact. We retain our Buy recommendation on the stock with an unchanged PT of Rs. 5,550.

**One-year forward P/E (x) band**




*Source: Sharekhan Research*

**Peer valuation**

| Particulars | CMP (Rs / Share) | O/S Shares (Cr) | MCAP (Rs Cr) | P/E (x) | | | EV/EBIDTA (x) | | | RoE (%) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | FY22 | FY23E | FY24E | FY22 | FY23E | FY24E | FY22 | FY23E | FY24E |
| Dr Reddy's | 4,251.0 | 16.6 | 70,737.0 | 32.3 | 20.7 | 18.2 | 13.3 | 10.9 | 9.1 | 11.4 | 16.4 | 16.4 |
| Cipla | 917.0 | 80.6 | 73,953.0 | 27.0 | 24.1 | 19.0 | 16.1 | 14.5 | 11.6 | 14.6 | 13.8 | 15.3 |
| Caplin Point Labs | 688.0 | 7.6 | 5,213.0 | 16.9 | 14.0 | 12.0 | 10.7 | 8.7 | 7.0 | 23.1 | 22.5 | 21.5 |

*Source: Company, Sharekhan estimates*

## About company

DRL is one of the leading pharmaceutical companies present across most markets globally. With respect to segments, global generics (generic formulations) is one of the key segments accounting for around 79% of the company's overall revenue. Under global generics, the company offers more than 400 high-quality generic drugs, keeping costs reasonable by leveraging its integrated operations. Generic formulations include tablets, capsules, injectables, and topical creams across major therapeutic areas of gastrointestinal ailments, cardiovascular disease, pain management, oncology, anti-infective, paediatrics, and dermatology. DRL is also present in APIs. The company is one of the leading manufacturers of API and partners with several leading generic formulator companies the world over. DRL, through the API business, focuses on innovation-led affordability, which offers customers access to the most complex active ingredients, while maintaining a consistent global quality standard. The proprietary business is the third business segment and accounts for around 6% of the company's overall sales. The proprietary products business focuses on developing differentiated formulations, which significantly enhance benefits in terms of efficacy, ease of use, and the resolution of unmet patient needs. DRL's wholly owned subsidiary – Aurigene Discovery is a clinical-stage biotech company committed to bringing novel therapeutics for the treatment of cancer and inflammation. The company has fully integrated drug discovery and development infrastructure from hit generation to clinical development. Aurigene Discovery has pioneered customized models of drug discovery and development collaborations with large and mid-size pharmaceutical companies.

## Investment theme

DRL is one of the leading pharmaceutical companies globally with a higher presence in the formulations segments and backward integration for select APIs. Globally, the company is present in most markets with the US and India accounting for ~37% and 17%, respectively, of overall sales. The company has a healthy compliance track record, which augurs well. DRL is at an inflection point, wherein performance is expected to improve remarkably. A confluence of cost control as well as productivity improvement measures, synergies through partnerships, strong execution, and product-specific opportunities would be key growth drivers for the company. Moreover, with the diversification of its base business, performance is expected to gather pace, backed by geographical expansion. A strong product pipeline in the US generic business would fuel US sales. On the other hand, a likely revival in acute therapies and expected traction in the acquired portfolio would be key drivers for the Indian business. Moreover, COVID-related opportunities, including the COVID-19 vaccine Sputnik V, offer a sizeable growth opportunity going ahead as the company looks to tap export markets for Sputnik V.

## Key Risks

1) Adverse regulatory changes can impact earnings prospects.

2) Currency risk.

## Additional Data

**Key management personnel**

| | |
|---|---|
| Mr. K Satish Reddy | Chairman |
| Mr. G V Prasad | Co Chairman and Managing Director |
| Mr. EREZ ISRAELI | Chief Executive Officer |

*Source: Company Website*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | BlackRock Inc | 4.34 |
| 2 | Life Insurance Corp of India | 4.22 |
| 3 | First State Investments ICVC | 3.65 |
| 4 | First Sentier Global Umbrella Fund | 3.05 |
| 5 | SBI Funds Management Pvt Ltd | 2.38 |
| 6 | Axis Asset Management Co Ltd/India | 1.79 |
| 7 | ICICI Prudential Life Insurance Co | 1.57 |
| 8 | Aditya Birla Sun Life Asset Manage | 1.42 |
| 9 | Vanguard Group Inc/The | 1.36 |
| 10 | DSP Investment Managers Pvt Ltd | 1.19 |

*Source: Bloomberg*

## Understanding the Sharekhan 3R Matrix

| | |
|---|---|
| **Right Sector** | |
| Positive | Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies |
| Neutral | Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies |
| Negative | Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability. |
| **Right Quality** | |
| Positive | Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance. |
| Neutral | Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable |
| Negative | Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet |
| **Right Valuation** | |
| Positive | Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment. |
| Neutral | Trading at par to historical valuations and having limited scope of expansion in valuation multiples. |
| Negative | Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple. |

*Source: Sharekhan Research*

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